

Executive Summary

Submission to the Senate Committee On National Finance Hearings on Equalization

October 30, 2001

By CUPE National

The idea of equalization was first introduced in 1957 with the objective to ensure that provincial governments can provide reasonably comparable public services at reasonably comparable levels of taxation. The Constitution of Canada, in Article 36.2, committed the Federal government to the Equalization principle. Every province since 1957 has received Equalization Payments at one time or another, except Ontario.

Today, the Federal government levies 60% of personal and corporate income tax, however, the provinces and local governments deliver roughly double the level of services of the Federal government¹. The Federal government is backing away from its commitment to funding social programs. The need for a proper Equalization Program is now even greater.

¹ Province of Manitoba, *2001 Budget*.

CUPE National represents more than 500,000 members who work in health care, social services, municipalities, libraries, schools and other public sectors across the country.

CUPE members are very concerned about the future of Equalization Payments in this country. We welcome this opportunity to present to you our views concerning the state of Equalization Payments in Canada.

Remove the Equalization Ceiling (and Floor)

For fiscal years 1988/89, 1989/90 and 1990/91, recipient provinces lost over \$3 billion in Equalization Payments due to the Equalization Ceiling. In the spring of 2001, the Ceiling is over 25% below where it was first set in 1982. All provinces and territories reiterated their support that the Equalization Ceiling should be removed at the Provincial and Territorial Ministers of Finance meetings in December 2000.

Fortunately, for the 1999/2000 fiscal year, *Bill C-18: An Act to Amend the Federal-Provincial Fiscal Arrangements Act*, removed the equalization Ceiling which greatly contributed to the recipient provinces. The Equalization Program floor should also be dropped since the Equalization formula alone is sufficient.

Move to the Ten-Province Standard

Ministers of Finance called for immediate work on the ten-province standard since, in the 1999/2000 fiscal year, \$3 billion in Equalization Payments were lost due to the use of the five-province standard in the Equalization formula.

The Equalization Formula: Renew the RTS formula, without Using Personal Income Taxes or One-off Funding

The Equalization Formula is the Representative Tax System (RTS) which incorporates over thirty [30] variables such as sales taxes, tobacco taxes, provincial income tax, corporate income tax, proxy bases, etc. Measurement of the RTS is not simple and subject to interpretation. A non-tax based measure, however, is not appropriate since different income is taxed at different rates.

Including all natural resources, however, makes Equalization Payments more volatile. One idea is to include 70% of natural resources from offshore, heavy oil, potash, and asbestos. When a five-province standard is incorporated, this may be a solution.

However, if a ten-province standard is used, resource revenues don't need to be given special attention. Natural resource revenues would already be included in the tax base of the ten provinces.

Building a Better Canada: Why a Proper Equalization Program is so Important Now

Poverty in Canada is growing. Government support for social programs, however, is shrinking. One way to reverse this trend is to renew the Equalization Program.

If allowed to continue, the present Equalization Program and diminished Federal-provincial transfers could lead to fiscally induced migration of people and businesses and Canadian instability. Without Equalization Payments, infrastructure and service delivery will vary greatly from province to province. Provinces may look to joining with other regions in order to gain.

The Federal Auditor General has raised the issue of accountability and Equalization Payments. Perhaps some relationship between Equalization Payments with social programs and minimum tax levels, may need to be explored.

Conclusion

Given the Federal surplus, changes are affordable. To build a strong Canada, we can't afford not to. The Equalization Ceiling and the five-province average were cost saving measures.

If ever Canada needed a Proper Equalization Program, it is now.



Submission to the Senate Committee

On National Finance:

Hearings on Equalization

October 30, 2001

By the

Canadian Union Public Employees

Introduction and Executive Summary

Equalization payments refer to funds that the federal government transfers to the poorer provinces to help equalize their financial capacity. Equalization payments enable public services to be delivered to every Canadian citizen regardless of income or geographical area. We, at CUPE, are seeing this Canadian ideal being dismantled. **An appropriate and renewed Equalization Program would revitalize equal access to public services and social programs**, no matter where in Canada you live, or your level of income.

CUPE National represents more than 500,000 members who work in health care, social services, municipalities, libraries, schools and other public services. We welcome this opportunity to present to you our views concerning the state of Equalization Payments in Canada.

CUPE is asking the Federal government to:

- **Remove the Equalization Ceiling (and Floor)**
- **Move to the Ten-Province Standard**
- **Renew the Representative Tax System (RTS) Equalization Formula, without Using Personal Income Taxes or One-off Funding**

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Today, the Federal government levies 60% of personal and corporate income tax, however, the provinces and local governments deliver roughly double the level of services of the Federal government². The Federal government is backing away from its commitment to funding social programs and public services. The need for a proper Equalization Program is now even greater.

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For fiscal years 1988/89, 1989/90 and 1990/91, recipient provinces lost over \$3 billion in Equalization Payments due to the Equalization Ceiling. In the spring of 2001, the Ceiling is over 25% below where it was first set in 1982. All provinces and territories reiterated their support that the Equalization Ceiling should be removed at the Provincial and Territorial Ministers of Finance meetings in December 2000.

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Ministers of Finance called for immediate work on the ten-province standard since, in the 1999/2000 fiscal year, \$3 billion in Equalization Payments were lost due to the use of the five-province standard in the Equalization formula.

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Building a Better Canada: Why a Proper Equalization Program is so Important Now

Poverty in Canada is growing. Government support for social programs, however, is shrinking. One way to reverse this trend is to renew the Equalization Program.

If allowed to continue, the present Equalization Program and diminished Federal-provincial transfers could lead to fiscally induced migration of people and businesses and Canadian instability. Without Equalization Payments, infrastructure and service delivery will vary greatly from province to province. Provinces may look to joining with other regions in order to gain.

The Federal Auditor General has raised the issue of accountability and Equalization Payments. Perhaps some relationship between Equalization Payments with social programs and minimum tax levels, may need to be explored.

In Summary

Given the federal surplus, changes are affordable. To build a strong Canada, we can't afford not to. The Equalization ceiling and the five-province average were cost saving measures.

CUPE is asking the Federal government to:

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If ever Canada needed a Proper Equalization program, it is now.

Historical Background

The idea of Equalization was first introduced in 1957 with the objective to ensure that provincial governments can provide reasonably comparable public services at reasonably comparable levels of taxation. By 1961 the Federal government, excluding intergovernmental transfers (including Equalization), was spending about the same amount as provincial and local governments combined on program expenditures. Equalization helped those provinces whose fiscal capacities were less than the national average. Every province since 1957 has received Equalization Payments at one time or another, except Ontario.

In 1982, the Equalization Formula was altered due to the imbalance created by energy revenues. Alberta and the Atlantic provinces were dropped from the formula in order to remove high and low distortions (respectively), thus creating the five-province average. Also, in 1982, Equalization Payments were capped at increasing no more than the increase in Gross National Product (GNP) from the 1982-83 fiscal year³. However, at the same time, the Constitution of Canada, in Article 36.2, committed the Federal government to the Equalization principle.

³ Caledon Institute of Social Policy, *Fiscal Federalism and You*, 1993, p.2.

Between 1990-91 to 1993-94, there was an “implicit cut” in Equalization Payments since the gap between the recipient and non-recipient provinces had narrowed. Ontario was also having financial problems, so this was affecting the entire country. However, the Equalization Formula on its own, created a stabilizing effect for the costs to the Federal government when this occurred⁴.

Fortunately, for the 1999/2000 fiscal year, *Bill C-18: An Act to Amend the Federal-Provincial Fiscal Arrangements Act*, removed the Equalization Ceiling which greatly contributed to the recipient provinces.

Today, the Federal government levies 60% of personal and corporate income tax, however, the provinces and local governments deliver roughly double the level of services of the Federal government⁵. The Federal government is backing away from its commitment to funding social programs. The need for a proper Equalization Program is now even greater.

CHST funding and Equalization

In 1999, CHST funding went to a per capita or per person system instead of a system based on need. This was to be implemented by the 2003-04 fiscal year. Quebec and Newfoundland would be the hardest hit, while Alberta, B.C. and Ontario (with the higher populations) would gain the most from this change.

⁴ Ibid.

⁵ Province of Manitoba, *2001 Budget*.

For instance, in 1999/2000, Newfoundland would have benefited from the CHST by approximately \$41.7 million. However, calculating the CHST on a per capita basis, Newfoundland's share dropped to about \$17 million – a \$24.7 million loss⁶.

The Federal government, however, has argued that this CHST loss would be offset by Equalization Payments to Newfoundland and Labrador. This argument is false. The 1999 Federal Budget contained changes to the Equalization Payments procedure. Quebec, Manitoba and Newfoundland were hit hardest with a loss in Equalization Payments of \$46 million, \$41 million and \$37 million respectively.

The Equalization Ceiling means that the new CHST increases do not go where they are needed the most. In fact, only the three most affluent provinces benefit, since the Equalization Ceiling “claws back” any benefit the other provinces may get.

Equalization Ceilings

The artificial Ceiling on Equalization Payments needs to be discontinued. All the provinces are in agreement on this point. The actual Equalization Formula will be the cost stabilizer for the Federal government.

⁶ Government of Newfoundland and Labrador, 1999.

Discontinue the Ceiling

The Equalization Ceiling is calculated by multiplying the percentage change in GDP for Canada over time by the base entitlement year. The Ceiling on Equalization Payments has been **lowered three times** during the past twenty years (since 1987) including 1999 – from 1.33% of GDP (1982-1987) to 1.04% of GDP (spring 2001)⁷. For fiscal years 1988/89, 1989/90 and 1990/91, recipient provinces lost over \$3 billion in Equalization Payments due to the Ceiling.

Bill C-18: An Act to Amend the Federal-Provincial Fiscal Arrangements Act removed the Ceiling for the 1999/2000 fiscal year. For Manitoba, as an example, removing the Ceiling meant \$800 million more. This was a recommended first step, however the Ceiling was re-imposed after this year.

The Equalization Program Ceiling is now “lower, as a proportion of GDP, than entitlements have ever been under the current five-province standard.”⁸ In the spring of 2001, the Ceiling is over 25% below where it was first set in 1982. Equalization Payments are presently at \$10.8 billion. The Equalization Ceiling is at \$10.82 billion. With an Equalization Ceiling this low, there is little room for Equalization Payments to increase next year.

⁷ Province of Manitoba, 2001.

⁸ Ibid.

Provincial Support for Discontinuing the Ceiling

All provinces and territories reiterated their support that the Equalization Ceiling should be removed at the Provincial and Territorial Ministers of Finance meetings in December 2000. During this meeting the Premiers stated “that the Federal government strengthen the Equalization Program including the immediate removal of the Ceiling on Equalization Payments, in concert with the restoration of the CHST and the adoption of an appropriate escalator [for the CHST]”. When disparities amongst provinces are increasing, the Ministers of Finance for the provinces and territories believe that it is appropriate that Equalization entitlements rise⁹.

The Cost of Using the Equalization Formula Without a Ceiling Will be Affordable

The cost of the Equalization Program declines as per capita fiscal disparities decrease, therefore an artificial Ceiling on Equalization Payments is not needed. For instance, if the Ceiling was removed, for the 2000/2001 fiscal year, it would only cost the Federal government \$1 billion more.

The Equalization Program Floor

The Equalization Program Floor also helps create volatility related to Equalization Payments. If a province’s Equalization entitlements decline between 5% and 15% (or approximately \$95 per person), the Equalization Floor is triggered. This is not likely to

⁹ Prov-Terr. Ministers of Finance Communiqué, Dec. 2000.

happen to recipient provinces, with the exception of Saskatchewan. The Equalization Program Floor should also be dropped since the Equalization Formula alone is sufficient.

Five to Ten: Province Average

Revenue-raising capacity is compared using the Equalization Formula in individual provinces against a five-province average. The five provinces used in this average are Ontario, B.C., Saskatchewan, Quebec and Manitoba. The standard has evolved from all provinces (three tax bases), to the top two provinces, to all provinces with exclusions for 50% resource revenue, to – what we have currently – the five-province standard.

Reintroduce the Ten Province Standard

Ministers of Finance called for “immediate work on the ten-province standard, including comprehensive revenue coverage and recognizing volatility around resource revenues” and “restoring the 5% cut made in the expenditure base in 1996/97 to the Territorial Formula Financing Program.”¹⁰

The Five Province Standard is Another Cut for Recipient Provinces

In the 1999/2000 fiscal year, \$3 billion in Equalization Payments were lost due to the use of the five-province standard. There is a \$295 per person difference between the five province and ten province standard (for all recipient provinces). When this is calculated for the 2000/2001 fiscal year, it equals about \$3.5 billion.

¹⁰ Ibid.

The Equalization Formula

The Equalization Formula is the Representative Tax System (RTS) which incorporates over thirty [30] variables. The variables represent sources of provincial and local government revenues, such as sales taxes, tobacco taxes, provincial income tax, corporate income tax, proxy bases, etc. Each province's overall ability to raise revenues from these sources on a per person basis is compared to that of the national standard (or five province standard presently). Provincial expenditures are not considered in the Equalization Formula.

Measurement of the RTS is not simple and is subject to interpretation. Proxy bases are used when tax practices differ widely and there is no common base. Some bases (e.g. property taxes, gaming, miscellaneous taxes and fees) can be interpreted differently.

A non-tax based measure, however, is not appropriate since different income is taxed at different rates. To use GNP productivity or personal income tax would not be appropriate for this reason. Revenue coverage, under the RTS, should be examined in the Federal government's review together with provincial governments, labour and other community groups and stakeholders.

Natural Resources

“The volatility of some provincial revenue sources, particularly natural resources, could be addressed.”¹¹ Excluding natural resources altogether as provincial revenues, however, is not appropriate. For instance, during the past two years when oil and gas prices have increased, provincial fiscal disparities have also increased. However, due to the low Ceiling, Equalization Payments were smaller.

Including all natural resources, however, makes Equalization Payments more volatile. One idea is to include 70% of natural resources from offshore, heavy oil, potash, and asbestos. When a five-province standard is incorporated, this may be a solution.

However, if a ten-province standard is used, resource revenues don't need to be given special attention. Natural resource revenues would already be included in the tax base of the ten provinces.

The Canada Census

Prior to 1991, if Census adjustments were incorrect in the formula calculation for Equalization Payments, they were corrected – both for Equalization Payments and Established Programs Financing. However, since 1991, this is not done, which also affects the recipient provinces negatively. A return to this procedure would be beneficial.

¹¹Province of Manitoba, 2001.

Using the Fiscal Stabilization Program

“The Fiscal Stabilization Program was amended to provide protection only in extreme cases of declining provincial revenue.” Before 1995, this program came into effect if provincial revenue declined by any amount¹². Currently, however, this program is for provinces, (territories are not covered), who experience a nominal 5% drop in revenue from the previous year. The program could possibly apply to Alberta or B.C. who could experience a decline following a resource “boom”, however, recipient provinces of Equalization Payments (with the possible exception of Saskatchewan) may never qualify. However, the Fiscal Stabilization Program could be used instead of an artificial Floor in the Equalization Program.

Building a Better Canada

Proper Equalization Payments is very important to Canada now. An appropriate program may also be affordable for the Federal government.

Canada Needs Proper Equalization Payments

Eliminating Poverty

The following table shows the significance of transfers as a percent of disposable family income. Transfers, increasingly, make up a significant part of a family’s income.

¹² Ibid.

Canada has the third worst child poverty rate – far greater than Germany, France, Netherlands and Sweden¹³.

Table: National Poverty Rates before and after The Impact of Transfers

| | All Households | | Two Adult-Working Families with Children | |
|---------|-----------------------|---------------------|---|---------------------|
| | <u>Before</u> | <u>After</u> | <u>Before</u> | <u>After</u> |
| U.S. | 25.3 | 17.7 | 15.4 | 12.7 |
| Canada | 22.9 | 11.2 | 12.6 | 6.4 |
| Germany | 22.1 | 5.5 | 3.1 | 1.5 |
| France | 34.5 | 8.2 | 18.7 | 2.1 |
| Sweden | 33.9 | 6.5 | 9.6 | 1.4 |

Source: OECD Economics Department Working Paper #189 Income Distribution and Poverty in Selected OECD Countries (1998)¹⁴.

Preventing Canadian Instability

If allowed to continue, the present Equalization Program and diminished federal-provincial transfers, could lead to fiscally induced migration of people and businesses and Canadian instability.

The Equalization Program keeps Canada together. All provinces can compete for economic growth and jobs since they provide comparable services at comparable tax rates. An equal “business climate” prevails.

¹³ Canadian Centre of Policy Alternatives, *Falling Behind*, 2000.

¹⁴ Canadian Centre of Policy Alternatives, *Falling Behind*, 2000, p.43.

“The authority to pay Equalization is now entrenched in the Constitution, thereby making these payments an integral part of the Canadian ‘fabric’. Equalization Payments effectively help bind together the various parts of the country. Yet the fabric soon may be wearing very thin.”¹⁵

Without Equalization Payments, infrastructure and service delivery will vary greatly from province to province. Provinces may look to joining with other regions in order to gain.

Accountability and Equalization Payments

Equalization Payments are provided on an unconditional basis. The Federal Auditor General has raised the issue of accountability with Equalization Payments. Perhaps some relationship between Equalization Payments with social programs and minimum tax levels may need to be explored.

Economic Development and Equalization Payments

Equalization Payments are not a disincentive to development (ie. Voisey’s Bay). There is no evidence to support this. For instance, per capita economic growth is slightly higher in recipient provinces than national average economic growth over the past 20 years. A recent study by Professors Richard Bird and François Vaillancourt showed that economic growth had been slightly higher in the recipient provinces than the other provinces, since the Equalization Program was introduced in 1957¹⁶.

¹⁵ Caledon Institute of Social Policy, *Fiscal Federalism and You*, 1993, p.2.

¹⁶ in Province of Manitoba- Budget Document, 2001.

Stability and Predictability of the Equalization Program

Allowing the Equalization Program to work without artificial Ceilings, Floors and standards would go a long way toward improving its stability and predictability.

One-off funding announcements to the provinces and territories is not an appropriate replacement for a proper Equalization Program. Focused responses to local needs will not provide stability or predictability.

Provincial Examples of How Equalization Payments are Spent

The following is a partial list of how Equalization Payments are spent:

- able to maintain comparable personal income tax rates which also helps encourage net migration which helps the shortage of skilled workers.
- training existing workers through new educational opportunities
- providing public services
- providing health care
- providing floodway protection, clean water etc.

The Federal Surplus

The Manitoba government has stated “It is unconscionable that the Federal government should be amassing surpluses by clawing back entitlements from the seven less affluent provinces in Canada”¹⁷. The Federal surplus for 2000/2001 is about \$10 billion.

¹⁷ Province of Manitoba, 2001.

Support for Equalization

A recent survey commissioned by the Centre for Research and Information on Canada (CRIC) in March of 2001, found that support for Equalization is high amongst Western Canadians. In Saskatchewan there is 89 percent support, while there is 78 percent support in Alberta. In Manitoba, 51 percent strongly support Equalization.

As mentioned previously, all provincial premiers support Equalization.

Conclusion

The reinstatement of an appropriate Equalization Program is badly needed in Canada. The removal of the Equalization Ceiling and Floor, and the reintroduction of the ten-province standard, would work towards this end. Provinces should not have to fund the major portion of social programs and public services.

Remove the Equalization Ceiling (and Floor)

The Equalization Ceiling and Floor need to be discontinued. Presently, Equalization Payments are at \$10.8 billion. The Equalization Ceiling is at \$10.82 billion. There is little room for Equalization Payments to increase - which they need to do.

All provinces agreed that there should be no Equalization Ceiling (during meetings in 1999 and 2000). Costs for the Federal government, are controlled, when disparities between the provinces are not great. The Fiscal Stabilization Program can be triggered (as a safeguard) if provincial revenues are too low.

Move to the Ten-Province Standard

Reintroducing the ten-province standard would help deal with the problem of natural resources causing Equalization Payments to be unpredictable. Provinces want the ten-province standard investigated, paying special attention to the issue of resource revenue volatility.

Renew the RTS formula, without using personal income taxes or one-off funding

What is considered provincial revenue is subject to interpretation. However, what is used today as revenue indicators is better than using a measure such as personal income tax. Personal income tax is taxed at different rates that would skew the Equalization Formula. Using GNP productivity would also cause problems. Together with provincial governments, labour, community groups and other stakeholders, revenue coverage, under the RTS, should be examined.

Why a Proper Equalization Program is so Important Now

The Rowell-Sirois Commission report of 1939/40 discussed the idea of Equalization Payments. It was drafted as a way to avoid having another depression. We need to rekindle this kind of thinking. An appropriate Equalization Program, as opposed to one-off funding, provides the provinces with stability and predictability for social programs, infrastructure renewal, etc.

With the current recession, the recipient provinces cannot afford to adequately meet social needs under the present federal funding programs of approximately 12%. In 1975, Federal support was about 24%. Federal support for provinces qualifying for Equalization fell over 40% over the period since 1981.

The Manitoba government has said that “it is simply unacceptable for the Federal government to build a multi-billion dollar surplus for the 2000/01 fiscal year while withholding \$1 billion in Equalization entitlements from the seven less affluent provinces in Canada.” In the study by G.C. Ruggeri – *A Federation Out of Balance*, it is argued that, without changes, the federal surplus in 2019-20 will be \$153.7 billion while the combined provincial/territorial surplus will only be \$13.9 billion. The Toronto-Dominion Bank has also come to a similar conclusion.¹⁸

¹⁸ Western Premiers Conference, 2001.

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If ever Canada needed a Proper Equalization Program, it is now.